HK economy set to remain under siege from virus; closed borders

DBS Bank has delivered its economic outlook for the Special Administrative Region, which it says will all ride on its continuing response to the pandemic.

The Hong Kong economy has entered 2021 in a challenging position, according to this report from Samuel Tse of DBS Bank Group Research. He says the much-needed rebound of asset prices and the broader economy will hinge crucially on the development of the Covid-19 pandemic and the eventual relaxation of immigration policies.

Looking specifically at the expectations for unemployment, the retail and tourism sector, and Hong Kong real estate markets, Tse says a further round of timely economic stimulus may be needed to avoid yet another wave of business closures across the Special Administrative Region.

Still, there are some positives to report. Tse says that with the Covid-19 now largely stabilised in China, DBS does expect that border to reopen at some stage early in the new year. This would create a “powerful pull factor” for the Hong Kong economy, he says.

The Singapore bank has revised its prediction for total GDP growth in 2021 up to 4.0%, from 0.5% previously.

Other conclusions drawn by the bank when it comes to Hong Kong immediate economic outlook include:

- Domestic demand remains weak; and tourism is moribund. That has pushed the jobless rate across the SAR to higher levels
- Another round of economic stimulus is urgently needed. This will help the Hong Kong economy to avoid yet another next wave of business closures
- There are some positive signs however, with the potential for the border with China to reopen during the first quarter of 2021. This would be a powerful pull factor for the economy
- The implication to DBS’ forecast, is that 2021 GDP growth has been revised up to 4.0%, from 0.5% earlier during the pandemic.

Unemployment is now at its highest levels since the SARS epidemic of 2003.

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Soaring unemployment

The unemployment rate rose to 6.4%, in 3Q from June – August, with the number of unemployed persons rising by 11,500. The underemployment rate stayed consistent at 3.8%, the highest level it has been seen at since during the SARS epidemic in 2003 (4.3%). This was due to the stringent

Rebound of the economy will hinge crucially on the COVID-19 pandemic social distancing rules amid the resurgence of new COVID cases in the quarter, which accounted for over 75% of the total cases in Hong Kong. Economic activities were partly halted, including in-restaurant dining, which was forbidden for most of that time. The worsening employment situation was also partially attributed to the increasing number of first-time unemployed job seekers – students recently graduated from university.

Against this backdrop, more noticeable increases were seen in the consumption and tourism-related sectors. Hong Kong's jobless rate rose further to 11.7%, from 10.8%. The unemployment rate could rise again if the border remains closed. Jobless rates of other sectors had already jumped between November 2019 and January 2020. These include the transportation sector, where unemployment rose to 5.9% from 2.2%.

Cathay Pacific announced plans to axe its subsidiary Cathay Dragon, and will implement a large scale lay-off plan, adding to that pain. A total of 5,300 local staff, spanning from cadet pilots to cabin crew, will be impacted. Its number of passengers dropped by 98.1% YoY in 2020, largely comparable to the 99% drop in total Hong Kong visitor arrivals.

As such, the number of unemployed persons will be expected to rise by 1.9%, and translate into another 0.1 percentage point increase in the headline unemployment rate.

Domestic demand for "staycations" helped push hotel occupancy rates back toward 50%

Retail sales by category

Source: DBS Bank Group Research

For now, Hong Kong has plans to open the border gradually with Singapore under the "Travel Bubble" agreement, that has been delayed since November. Yet, visitors from the Lion City only account for 0.8% of total visitor arrivals, or 1.5% of total tourist spending. Should the situation turn south again, the jobless rate will soar in the months ahead. In fact, tourist spending accounts for around 30% of Hong Kong's total retail sales value. That said, the consumption sector could at most achieve 70% of their revenue with local spending.

Not too over-optimistic on relief in retail sales

The relative improvement in retail sales, which narrowed from -44.0% YoY in February to -13.1% in August, was largely a result of the low-base comparisons. The retail sales value has recorded negative growth since February, 2019, due to the economic slowdown in China, and the RMB depreciation amid the China-US trade war.

The contraction has further widened since June 2019, when Hong Kong experienced an unprecedented 6-month period of social unrest. Retail sales dropped by 30% YoY in the second half of 2019.

The performance of tourist hot-picks such as jewellery and clothing remained subdued. The hotel occupancy rate rebounded from 29% in February to 50% in August, due to unusual demand from 'staycations' – domestic holidaymakers enjoying local stays. Yet, the overall room rate after discounted by CPI dropped to HK$632 per night, even lower than the HK$660 rate during SARS in 2003.

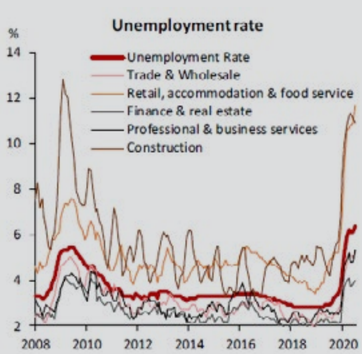
Fiscal constraints kicked-in

Against this backdrop, another round of timely stimulus package is needed to avoid the next wave of business closures.

The budget deficit as a percentage of GDP is expected to reach 11.1% in the 2020-21 financial year, up from 0.4% previously. This was the strongest fiscal stimulus ever. However, another round of rescue packages was restrained by the fiscal reserve, which could maintain government expenditure for another 12 months.

Further stimulus will require the government to issue new bonds. The structural decline of the labour force, resulting from the ageing population, will also increase the need to issue sovereign bonds over the longer term. The Hong Kong Government forecast that the workforce would continue to shrink after the economy recovers from the Covid-19 pandemic in its latest Labour Force Projection (issued in September). These will challenge the mandate of "keeping the expenditure within the limits of revenues in drawing up its budget" stated in the Basic Law

Hong Kong's changing unemployment rate



Source: DBS Bank Group Research

– the mini-constitution of Hong Kong.

Setting political obstacles aside, enlarging the scale of debt issuance will likely fuel nominal interest rates. Coupled with the deteriorating credit rating of the city, we may see some upward pressure on government bond yields. This was reflected by the hike in the iBond guaranteed yield. This is the first time HKMA guaranteed a yield higher than the concurrent inflation rate. Fortunately, the burden of debt servicing remains manageable as government debt and debt guaranteed by the government has stayed low, and was at 2.4% in August.

The deflation risks will, in turn, increase real interest rates as well, which reached the post-Global Financial crisis high of 3.2% in August. CPI fell by 2.3% YoY and 0.4% in July and August respectively, the first deflation recorded in three years. Hong Kong's last persistent deflation spanned 68 months over 1998-2004, when it endured four major economic shocks.

Hopefully, the deflation could ease on the back of an ultra-low interest rate environment. Otherwise, a persistently high real borrowing cost will damage the recovering economy.

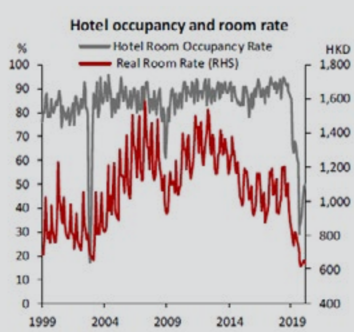
Diverging property price movements

Residential property prices on the secondary market have fallen 7.7% from their peak before the social movement in June 2019, or 1.3% YTD. The third wave of outbreak has weighed on both transactions and prices. Prices set by developers in the primary market have been less aggressive lately. For instance, the initial average selling price (ASP) of The Pavilia Farm, the latest development co-constructed by New World Development and MTR, was at HK$18,921 per square foot. This is largely comparable to those on secondary market in the same district.

Joblessness in the construction could cause delays of some ongoing projects in the months ahead

Hong Kong GDP projected to rebound by 4% this 2021

Hotel occupancy and room rates



Source: DBS Bank Group Research

In the rental market, the rising unemployment rate, especially in the low-paying sectors, has already translated into downward pressure on residential rental fees (-7.8% YoY). Likewise, retail shop rents also fell substantially due to weak retail sales performance.

Looking ahead, home prices are expected to show divergent movements. The mass market should stay largely resilient due to the long-term demand-supply imbalance. Short-term supply will remain tight due to the pandemic. The jobless rate of the construction sector, stayed at 10.9% for much of 2020, the highest level last seen during the Global Financial Crisis. This points to the possible delay of construction works in the months ahead. Over the medium-long term, Hong Kong will need extra 9,080 hectares of land due to the increasing ageing population, ageing residential property, as well as increasing demand for larger living spaces.

However, the current land reserve is only 5,000 hectares, including the yet-to-be-approved reclamation project Lantau Tomorrow. Property market indicators such as negative equity (0.1% of total outstanding mortgages), loan-to-value ratio (56.7 in March, 2020 compared to 68.9 in September, 2002), and affordability ratio (41.1 in June, 2020 against 64.4 in June, 1997) point to a relatively low default risk. The long-term demand-supply imbalance, as well as the ultra-low interest rate environment, should continue to serve as a buffer for this asset class.

Yet, we should see more downside risks for the luxury real estate market in the months ahead. The cloudy economic environment may lead business owners to liquidate their assets. Should the border remain closed amid the unstable Covid-19 situation, investment demand from Mainland investors for large units will remain subdued. We expect the overall residential prices to stay flat with some fluctuation in 2021.

To conclude, the rebound of asset prices and economy will hinge crucially on the development of COVID and the relaxation of immigration policies. Economic growth is projected to remain negative due to the third wave of COVID outbreak but narrow to -5.6% YoY in 3Q and -4.1% in 4Q to conclude the year at -7.0%.

With the largely stabilized COVID outbreak in China, we expect the border will re-open in the first quarter of 2021. GDP could thereby rebound by 4.0% next year.